CHAPTER 7

TAXATION OF BUSINESS ORGANIZATIONS

Equity investment in the corporate sector is discouraged by the relatively high effective rate of taxation imposed on the return from such investment. The only relief provided by current law from the relatively high rate, caused by the double taxation of corporate dividends, is the exclusion available to individual shareholders for the first $100 of dividend income received. The Treasury Department proposes to repeal this exclusion and to institute a corporate-level deduction for 50 percent of previously taxed corporate earnings paid out as dividends.

Investors are able to form limited partnerships that closely resemble corporations, but are not so treated for tax purposes. The Treasury Department proposal would classify certain large limited partnerships as corporations subject to the corporate income tax.

REDUCE DOUBLE TAXATION OF CORPORATE EARNINGS DISTRIBUTED TO SHAREHOLDERS

General Explanation

Chapter 7.01

Current Law

In general, corporations are treated as taxpaying entities separate from their shareholders for Federal income tax purposes. Thus, a corporation separately reports and is directly taxable on its income. Correspondingly, the income of a corporation is not taxable to its shareholders until actually distributed to them. An exception to these rules is provided on an elective basis under Subchapter S of the Code. Taxable income of an S corporation is allocated among and taxed directly to its shareholders. This pass-through tax regime is limited to corporations meeting certain requirements, including that the corporation have only one class of stock and 35 or fewer shareholders.

Dividends paid by corporations other than S corporations are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Corporate shareholders generally are taxed on only 15 percent of dividends received from other corporations, and are not subject to tax on dividends received from certain affiliated domestic corporations, such as controlled subsidiaries. Corporations are not entitled to a deduction for dividends paid to shareholders. Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax. Corporations are permitted, however, to deduct interest paid on corporate indebtedness, even if paid to creditors who also are shareholders.

Corporate distributions to shareholders generally are taxable "dividends" to the extent of (i) the corporation's earnings and profits in the year of distribution plus (ii) earnings and profits accumulated in prior years. In concept, a corporation's earnings and profits represent its ability to make distributions to shareholders without impairing invested capital. Thus, earnings and profits, in general, measure economic income of the corporation available for distribution to shareholders. Distributions to shareholders in excess of current and accumulated earnings and profits first reduce the shareholders' basis in their stock, and, to the extent of the excess, are taxed as amounts received in exchange for the stock.

If a corporation redeems its stock from a shareholder, the distribution from the corporation generally is treated as a payment in exchange for the stock and any resulting gain to the shareholder is taxed as a capital gain. Similarly, amounts received by a shareholder in a distribution in complete liquidation of the corporation are treated as payments in exchange for the stock. Such sale or exchange treatment also applies to distributions in partial liquidation to noncorporate shareholders.

Reasons for Change

Distortions in Economic Behavior. The disparate tax treatment of debt and equity in the corporate sector distorts a variety of decisions concerning a corporation's capitalization as well as its policies with regard to investment or distribution of earnings. Because interest payments are deductible by a corporation and dividend distributions are not, corporate earnings distributed to shareholders are subject to both corporate and shareholder income taxes, whereas corporate earnings distributed as interest are taxable only to the creditor. The effective double taxation of dividends encourages corporations to finance their operations with debt rather than equity. This reliance on debt capital increases the vulnerability of corporations both to the risks of bankruptcy and to cyclical changes in the economy.

The different treatment of interest and dividends under current law also places great significance on rules for distinguishing debt from equity. Historically, the distinction for tax purposes has rested on a series of general factors which have been given different weight depending on the circumstances of the taxpayer and on the particular court making the determination. This approach has increasingly generated uncertainty, especially as more sophisticated financial instruments have merged the traditional characteristics of debt and equity. Although attempts have been made to formulate and codify more or less mechanical tests for distinguishing debt from equity, no consensus exists concerning the proper criteria for such tests. Considerable uncertainty thus remains under current law as to whether instruments will be treated as debt or equity for tax purposes.

The double taxation of earnings distributed as dividends to shareholders also affects corporate distribution policy in ways that detract from the efficiency of the economy. Corporations with shareholders in relatively high tax brackets are encouraged to retain earnings, in order to defer shareholder level income tax. Corporations with shareholders who are tax exempt or in relatively low tax brackets are encouraged to distribute earnings, so that the shareholders may invest those earnings without bearing future corporate-level income tax. These incentives for or against distribution of earnings interfere with ordinary market incentives to place funds in the hands of the most efficient users.

The double taxation of corporate earnings distributed to shareholders also increases the cost of capital for corporations and discourages capital-intensive means of production in the corporate sector. Similarly, double taxation discriminates against goods and services that are more readily produced or provided by the corporate sector as well as activities customarily engaged in by corporations. Investors are thus discouraged from using the corporate form, even in circumstances where nontax considerations make it desirable. The elective provisions of Subchapter S provide only limited relief from these effects.

Proposal

Deduction for Dividends Paid. The double taxation of corporate earnings distributed as dividends would be partially relieved under the proposal by allowing domestic corporations, other than those subject to special tax regimes (e.g., regulated investment companies), a deduction equal to 50 percent of dividends paid to their shareholders ("dividends paid deduction"). The amount of dividends subject to the dividends paid deduction would be limited, however, to ensure that the deduction is allowed only with respect to dividends attributable to corporate earnings that have borne the regular corporate income tax. Thus, relief from double taxation of dividends would be provided only when the income with respect to which the dividends are paid is actually taxed at the corporate level. The dividends paid deduction, therefore, would not be available with respect to corporate distributions from so-called tax preference income.

The limitation on the source of deductible dividends would be provided by requiring every corporation to maintain a Qualified Dividend Account. The amount of dividends with respect to which a deduction could be claimed in any taxable year would be limited to the Qualified Dividend Account balance as of the end of the year during which the dividends were paid. Dividends paid during a taxable year in excess of the Qualified Dividend Account balance as of the end of the year would not be eligible for the dividends paid deduction. Moreover, these excess dividends could not be carried forward and deducted with respect to amounts added to the Qualified Dividend Account in subsequent years.

The Qualified Dividend Account would consist of all earnings that have borne the regular corporate tax, less any deductible dividends paid by the corporation. Thus, the Qualified Dividend Account would be increased each year by the amount of the corporation's taxable income (computed without regard to the dividends paid deduction). The amount of taxable income added to the Qualified Dividend Account each year, however, would be reduced by the amount of any taxable income that, because of any allowable credit, did not actually bear the corporate tax. For this purpose, foreign tax credits would be treated the same as any other credit. The Qualified Dividend Account would thus include none of the corporation's tax preference income.

The Qualified Dividend Account would be decreased each year by the amount of any dividends paid by the corporation with respect to which a dividends paid deduction was allowable. Dividends paid during a year in excess of the Qualified Dividend Account balance as of the end of the year, however, would have no effect. Thus, the Qualified Dividend Account balance would never be reduced below zero. As described below, the Qualified Dividend Account also would be reduced to reflect distributions in redemption or in partial or complete liquidation.

The Qualified Dividend Account balance would be indexed to account for inflation. Rules would be provided to govern the transferability of the Qualified Dividend Account in mergers and acquisitions.

The dividends paid deduction allowed to corporations would be treated similarly to other business deductions. For example, the deduction would enter into the determination of a corporation's net operating loss and thus could be carried back and forward. Similarly, the dividends paid deduction would be taken into account for purposes of computing a corporation's estimated tax liability.

Distributions in Redemption, Partial Liquidation, and Complete Liquidation, and Other Corporate Distributions. A corporation would be entitled to the dividends paid deduction with respect to distributions in redemption of stock, including distributions in partial or complete liquidation. Consequently, the Qualified Dividend Account would be reduced by the amount of the redemption or liquidation proceeds with respect to which the corporation was entitled to a deduction.

In the case of a distribution in complete liquidation, the liquidating corporation would be entitled to a dividends paid deduction as though it had distributed dividends in an amount equal to the Qualified Dividend Account balance at the time of the liquidation (but not in excess of the amount of the liquidation proceeds).

In the case of a distribution in redemption or partial liquidation, the corporation would be entitled to the dividends paid deduction as though it had distributed dividends equal to a specified portion of the corporation's Qualified Dividend Account. The portion of the Qualified Dividend Account treated as distributed would be computed using a method similar to the one used under current law to compute the portion of a distribution in redemption that is properly chargeable to earnings and profits. Accordingly, the portion of the Qualified Dividend Account treated as distributed in redemption or partial liquidation generally would be proportionate to the amount of the corporation's outstanding stock that is redeemed (but not in excess of the amount of proceeds distributed to shareholders).

Under current law, certain transactions not formally denominated as dividends by distributing corporations are treated as dividends for tax purposes. These transactions include certain redemptions (section 302(d)), certain stock purchases by corporations related to the issuer (sections 302(d) and 304), certain stock dividends (sections 305(b) and (c)), certain sales and other distributions of preferred stock (section 306), and certain "boot" received in otherwise tax-free reorganizations or divisions (sections 356(a)(2), 356(b), and 356(e)). Corporations making distributions to shareholders in such transactions would be permitted to treat the distributions as dividends subject to the dividends paid deduction, provided that the corporations treated the distributions as dividends for information reporting purposes. In the event a distributing corporation did not treat such a distribution as a dividend for information reporting purposes and therefore did not claim a dividends paid deduction, the Internal Revenue Service would have the authority to allow the deduction if the transaction were subsequently characterized as a dividend and the corporation and shareholder treated the transaction consistently.

Intercorporate Investment. The treatment under the proposal of dividends paid to corporate shareholders would ensure that the relief from double taxation of corporate earnings would not be available until the earnings were distributed outside the corporate sector. In addition, current law applicable to the receipt of dividends by corporate shareholders would be changed to eliminate the small portion of certain dividends (generally 15 percent) that is subject to more than two levels of tax.

Under the proposal, a corporation paying dividends would compute its dividends paid deduction without regard to whether the recipient shareholders were corporations. A payor corporation, however, would be required to report to its corporate shareholders the portion of dividends paid to such shareholders that was allowable as a deduction to the payor corporation.

Corporate shareholders would be required to include in their taxable income the portion of dividends for which the payor corporation received the dividends paid deduction. Accordingly, the dividends received deduction allowable under current law would be reduced to 50 percent of deductible dividends received. A 100 percent dividends received deduction would be allowed, however, with respect to dividends that were not deductible by the payor corporation. Thus, a corporate shareholder would be entitled to a 100 percent dividends received deduction with respect to dividends paid in excess of the payor corporation's Qualified Dividend Account balance.

Although a corporate shareholder generally would be taxed on only one-half of the dividends it receives, the full amount of such dividends would increase the corporate shareholder's own Qualified Dividend Account balance. This full increase would ensure that the relief from double taxation is not diminished simply because of the existence of multiple layers of corporate shareholders.

A foreign corporation would not be eligible for the dividends paid deduction. However, the dividends received deduction allowable under current law with respect to dividends received by a domestic corporate shareholder from a foreign corporation's earnings subject to United States corporate tax would be increased to 100 percent of such dividends received.

The current law rules that fully tax certain dividends received by corporate shareholders would not be changed by the proposal. If, therefore, a corporate shareholder would not be entitled to a dedution under current law with respect to the receipt of a particular dividend, the dividend would not be subject to the special intercorporate rules of the proposal. Accordingly, the payor corporation would be eligible for a deduction with respect to the dividend paid, the full amount of the dividend would be taken into account in computing the corporate shareholder's taxable income, no dividends received deduction would be allowed to the shareholder, and no special rules would be used to compute the shareholder's Qualified Dividend Account.

The application of these intercorporate rules may be illustrated by assuming that a wholly owned subsidiary corporation with a Qualified Dividend Account balance of $1,500 paid a $500 dividend to its parent corporation. The entire $500 dividend would be eligible for deduction by the subsidiary, which would thus be entitled to a dividends paid deduction of $250 and would be required to reduce its Qualified Dividend Account by the amount of the dividend to $1,000. The subsidiary also would be required to inform its parent that it was allowed a $250 dividends paid deduction with respect to the $500 dividend. The parent would thus include $500 in its gross income and would be entitled to a $250 dividends received deduction. The parent would thus be taxed on one-half of the dividends received from its subsidiary. The parent's Qualified Dividend Account, however, would be increased by $500 with respect to the dividend received.

In summary, the subsidiary corporation would be subject to tax on $250 with respect to the earnings from which the dividend is treated as having been paid. In addition, if the parent corporation made no distributions to its shareholders, it would be subject to tax on $250 of income with respect to the intercorporate dividend. Under current law, an equivalent $500 of income would be taxed to the two corporations, although the entire amount would be taxed to the subsidiary. The proposal thus imposes the full measure of the corporate tax, but no more than that, in the case of intercorporate dividends that are not distributed outside the corporate sector.

If, however, the parent paid $500 in dividends to its shareholders, all of whom were individuals, it would be entitled to a $250 dividends paid deduction. Accordingly, the parent would not be subject to any tax with respect to the earnings attributable to the intercorporate dividend and, while the individual shareholders have been taxed on the distribution, one-half of the double taxation would thus be relieved. The parent's Qualified Dividend Account would be reduced by $500 with respect to the dividends paid to its shareholders.

Treatment of foreign shareholders. A compensatory withholding tax would be imposed on dividends paid to foreign shareholders who are not entitled to the benefits of a bilateral tax treaty. The compensatory withholding tax rate would equal the corporate income tax rate times the percentage of dividends that is eligible for the dividends paid deduction. Thus, the compensatory withholding tax rate would be 16.5 percent (50 percent of the corporate income tax rate). Dividends that were not eligible for the dividends paid deduction, because they exceeded the balance in the corporation's Qualified Dividend Account, would not bear the compensatory withholding tax. The compensatory withholding tax would be imposed in addition to the basic 30 percent withholding tax on dividends paid to foreign shareholders who are not entitled to treaty benefits. In addition, subject to the reservations expressed in the Analysis section of this chapter, the compensatory withholding tax would not be imposed on dividends paid to foreign shareholders entitiled to treaty benefits.

Earnings and Profits. The measurement of the extent to which corporate distributions to shareholders constitute dividends would continue to be based on the payor corporation's current and accumulated earnings and profits. Earnings and profits would continue to be a measure of the economic income of the corporation. The precise definition of earnings and profits, however, would be modified as necessary to reflect other proposed changes. In addition, earnings and profits accumulated after the effective date would be indexed to account for inflation.

Effective Date

The proposal generally would be effective on January 1, 1987. The relief from double taxation would be phased in over six years, with a 25 percent deduction allowed with respect to dividends paid in 1987 and a five percentage point increase in the deduction for each of the next five calendar years. Accordingly, the 50 percent dividends paid deduction would apply in 1992 and later years.

Similarly, the reduction in the current law dividends received deduction for corporate shareholders would be phased in over six years, with a 75 percent deduction allowed with respect to deductible dividends paid in 1987 and a five percentage point decrease in the deduction for each of the next five calendar years. A 50 percent dividends received deduction with respect to deductible dividends would thus begin to apply in 1992. The compensatory withholding tax imposed on foreign shareholders not entitled to treaty benefits also would be phased in from 8.25 percent (25 percent of the corporate tax rate) in 1987 to 16.5 percent (50 percent of the corporate tax rate) in 1992 and later years.

The Qualified Dividend Account would include taxable income only for taxable years beginning after December 31, 1986. In addition, dividends paid after December 31, 1986, in taxable years beginning before January 1, 1987, would be treated for purposes of the dividends paid deduction as having been paid during the first taxable year beginning after December 31, 1986. Finally, current law would continue to apply to dividends paid with respect to preferred stock issued prior to January 1, 1987.

Analysis

In General. The proposal would reduce the existing incentive for corporations to raise capital by issuing debt and would make equity securities more competitive with debt. Because dividend relief also would reduce the incentive to retain earnings, corporations would be likely to pay greater dividends and to seek new capital, both equity and debt, in the financial markets. Corporations would thus be subject to greater discipline in deciding whether to retain or how to invest their earnings. The increased level of corporate distributions would expand the pool of capital available to new firms. This should, in turn, enhance productivity and efficiency across the economy.

Effect of Reduction in Tax Rates. Under current law, corporate earnings paid out as dividends to an individual shareholder in the highest tax bracket may be subject to an overall tax rate of 73 percent (46 percent on the earnings at the corporate level and 50 percent on the after-tax amount of the dividend at the individual shareholder level). Because interest payments are deductible by the corporation, earnings paid out as interest to an individual creditor are taxed at a maximum rate of only 50 percent. Consequently, earnings distributed as dividends are relatively overtaxed by 23 percentage points. Without other changes, lowering the maximum corporate rate to 33 percent and the maximum individual rate to 35 percent would reduce the relative overtaxation only by a small amount, from 23 points to approximately 21 points. Therefore, the reduction in tax rates proposed by the Treasury Department would not reduce the need for relief from the double taxation of dividends. Under the proposal for partial dividend relief, the maximum overall tax rate on corporate earnings distributed as dividends to individual shareholders would be approximately 45 percent. This rate exceeds the maximum rate on corporate earnings paid out as interest by approximately ten percentage points.

Effects on Specific Industries. Industries and firms that distribute a large fraction of their earnings as dividends are more seriously affected by the current double taxation of dividends. The proposal, therefore, may increase the flow of resources to these industries. Prime examples of industries that may derive relatively greater benefit from the dividends paid deduction are the communication industry and public utilities, such as electric, natural gas, and sanitary utilities. These industries each distributed approximately 100 percent of their after-tax profits as dividends during the period from 1980 through 1983.

Foreign Experience. The United Kingdom, France, West Germany, Japan, Canada, and other countries have adopted tax regimes that partially relieve the double taxation of dividends. Many of these countries enacted relief for policy reasons that do not apply equally to the United States, and have chosen different systems than the one proposed by the Treasury Department. As shown in Appendix C of Volume I of this Report, the extent of dividend relief provided by these countries ranges from 38 percent to 100 percent. The Treasury

Department proposal, for a 50 percent dividends paid deduction, would provide more relief than Japan (at 38 percent) or Canada (at 40 percent), the same as France, and less than Germany (at 100 percent) or the United Kingdom (at 80 percent after 1986). In sum, the proposal would bring the taxation of corporate dividends in the United States more in line with that imposed by some of its major trading partners.

Treatment of Foreign Shareholders. Most of the countries that have adopted some form of relief from the classical system of double taxation of corporate earnings distributed to shareholders have denied part or all of the benefits of that relief to foreign shareholders, although some countries have granted dividend relief to foreign shareholders through bilateral tax treaties. The United States has been only partially successful in obtaining the benefits of other countries' dividend relief provisions for its citizens and residents.

The most common method of dividend relief that has been adopted by these countries is the so-called "imputation" system. Under such a system, shareholders include in income and are entitled to claim a credit for a portion of corporate taxes paid on distributed earnings. The benefits of such a system usually are denied to foreign shareholders simply by allowing only domestic shareholders to obtain the credit for taxes paid by the corporation.

In contrast to the imputation system adopted in many countries, the proposal would allow domestic corporations a deduction equal to one-half of certain dividends paid to their shareholders. The benefits of this dividend deduction system could be denied to foreign shareholders by imposing a compensatory withholding tax on deductible dividends paid to foreign shareholders. The amount of the compensatory withholding tax would exactly offset the deduction allowable to the payor corporation.

Virtually all United States bilateral tax treaties, however, establish a maximum rate at which withholding taxes may be assessed on dividends. Those treaty provisions would be directly violated if the benefits of the dividends paid deduction were denied to foreign shareholders by imposing a compensatory withholding tax on dividends paid to residents of treaty countries.

Countries using the imputation system have avoided this treaty difficulty, while denying the benefits of dividend relief to foreign shareholders, because, as a purely formalistic matter, no increased withholding tax is imposed when the ability to obtain the credit is limited to domestic shareholders. Accordingly, the denial of the benefit to foreign shareholders technically does not result in a direct treaty violation.

As a matter of economic substance, there is no difference between denying foreign shareholders a credit for corporate taxes paid under an imputation system of dividend relief and imposing a compensatory withholding tax on distributions to foreign shareholders under a dividends paid deduction system. Because the two schemes are economically equivalent, it would be unwarranted to adopt an imputation system, rather than a dividend deduction system, merely to avoid technical treaty violations. Moreover, in the context of the United States economy and tax system, an imputation approach to dividend relief would be extremely cumbersome. A dividend deduction system, therefore, has been proposed.

Because the United States benefits significantly from its bilateral income tax treaties and takes seriously its obligations under those treaties, it is reluctant unilaterally to violate the treaties. Accordingly, subject to the concerns expressed below, the proposed compensatory withholding tax initially would not be imposed with respect to dividends paid to shareholders resident in treaty countries and the benefits of dividend relief thus would be extended unilaterally to such shareholders.

This unilateral extension of dividend relief to certain foreign shareholders is troubling in two respects. The first concern involves "treaty shopping," which is the use, through conduit corporations, of tax treaties by residents of non-treaty countries. Only a limited number of treaties presently lend themselves to abuse in this way and negotiations aimed at resolving this problem with these countries are continuing. The incentives to engage in treaty shopping, however, may be increased under the proposal. Therefore, efforts to eliminate treaty shopping would be intensified. If it is not possible to resolve this problem in the very near future, then the United States should, at a minimum, refuse to allow the benefits of the dividends paid deduction to persons claiming benefits under treaties that lend themselves to treaty shopping.

Second, as already noted, countries with imputation systems generally have not unilaterally extended the benefits of dividend relief to United States residents, although several have extended some or all of the benefits through treaty negotiations. The United States would expect that countries that have not previously done so would extend the benefits of their dividend relief rules to United States residents. Treaty negotiations would thus be undertaken with that view. Unwillingness of treaty partners to negotiate meaningfully on this issue would cause a reevaluation of the decision unilaterally to extend benefits to foreign shareholders in treaty countries. The Treasury Department expects to work closely with United States treaty partners and Congress in assessing concerns and progress in these areas.

Transition Issue: Effect on Share Prices. The double taxation of corporate earnings distributed as dividends probably has resulted in corporate shares trading at lower prices than would have occured if all corporate income were taxed only once. Reducing or eliminating the second level of tax might initially cause share prices to rise. Most current owners of corporate shares acquired their shares at prices that reflected a discount for most or all of the expected double tax on corporate income. Consequently, reducing the double tax would reward many who did not bear the effect of current law on share prices, producing windfall profits for those shareholders. For this reason, any relief from the double taxation of corporate earnings distributed to shareholders should be phased in over time.

Scope of Proposal. Other than the proposal for partial relief from the double taxation of dividends, the Treasury Department proposals do not address the general principles of current law governing taxation of corporations and shareholders. Thus, in general, no proposals have been made regarding the taxation of corporate liquidations, reorganizations, or the carryover of corporate tax attributes, including net operating losses. The rules in these areas are frequently cited as in need of reform, and important work has been undertaken in a number of sectors to rationalize and simplify current law. The Treasury Department is interested in and supportive of efforts to reform current rules for the taxation of corporations and shareholders. No inference to the contrary should be drawn from the fact that these issues have not been addressed in the Treasury Department proposals.

REPEAL $100/$200 DIVIDEND INCOME EXCLUSION

General Explanation

Chapter 7.02

Current Law

Dividend income received by an individual generally is subject to Federal income taxation. There is, however, an exclusion from gross income for the first $100 of dividend income received by an individual from domestic corporations. In the case of a husband and wife filing a joint return, the first $200 of dividend income is excluded regardless of whether the dividend income is received by one or both spouses.

Reasons for Change

The $100 dividend exclusion narrows the base of income subject to tax without creating a proportionate incentive for investment in domestic corporations. The exclusion provides no marginal investment incentive for individuals with dividend income in excess of $100, and only a minor incentive for other individual taxpayers. In addition, the partial dividends-received exclusion contributes to complexity in the tax system by adding an extra line (and two entries) on the individual tax Form 1040 and two lines on the Form 1040A.

Proposal

The partial exclusion for dividends received by individuals would be repealed.

Effective Date

The provision would apply to taxable years beginning on or after January 1, 1986.

Analysis

Repeal of the dividend exclusion is not likely to have a significant effect on aggregate economic behavior. The great majority (76 percent) of taxpayers who receive dividends claim the full amount of the dividend exclusion. For these taxpayers, repeal of the exclusion would have no effect on marginal tax rates and thus should not affect investment decisions. Even for those taxpayers who do not receive sufficient dividends to claim the full amount of the exclusion, repeal should not have a significant impact. Although the current marginal rate of tax for such persons on additional dividends (up to the amount of the exclusion) is zero, the relatively small tax savings available from the exclusion (up to $50 for individuals and $100 for joint returns, assuming a maximum tax rate of 50 percent) is not a substantial investment incentive.

TAX LARGE LIMITED PARTNERSHIPS AS CORPORATIONS

General Explanation

Chapter 7.03

Current Law

In general, business organizations treated as corporations are separate taxable entities for Federal income tax purposes. Thus, a corporation separately determines and reports its income and is directly taxable on such income. A corporation's income is not taxable to its shareholders until actually distributed to them, and corporate losses do not pass through to shareholders, but must be absorbed, if at all, against corporate income.

In contrast to the tax treatment of corporations, business organizations treated as partnerships are not separate entities for tax purposes. Although a partnership determines and reports its income as though a separate entity, it has no direct liability for tax. Instead, each item of partnership income, gain, loss, deduction or credit flows through to its partners, who must report such items on their respective separate tax returns.

Under Treasury regulations, business organizations are treated as corporations or partnerships for tax purposes depending on the extent to which they possess the following characteristics found in a "pure" corporation: continuity of life; centralization of management; limited liability; and free transferability of interests. Business organizations not possessing a "preponderance" of corporate characteristics are treated as partnerships.

Current law also permits corporations which meet certain requirements to elect to be treated as S corporations for tax purposes. An S corporation is not subject to the corporate income tax. Instead, its income and losses flow through to its shareholders and are reported by them on their respective separate tax returns. Among the requirements for S corporation status is that the corporation have no more than 35 shareholders.

Reasons for Change

The existing rules for distinguishing partnerships and corporations are inadequate. They permit many organizations, not formally incorporated but having most of the practical attributes of corporations, to be treated as partnerships for tax purposes. These rules in turn have permitted investors in such a partnership to receive pass-through tax treatment with respect to the partnership's income and loss even though their economic relationship to the partnership and with other partners is in important respects indistinguishable from that of shareholders of a comparably sized corporation.

In large part, the pass-through characteristics of the partnership form have been exploited by investment tax shelters organized as limited partnerships. These tax shelter partnerships draw capital from a diverse and widely situated group of investors. Moreover, because of the legal characteristics of a limited partnership, the investor limited partners are not active in the day-to-day management of the enterprise, are protected from loss in excess of their investment, and frequently face minimal restrictions on transfer or assignment of their interests. In short, the limited partnership vehicle offers many of the investment and legal characteristics of a corporation, yet under current law is treated for tax purposes as a partnership.

The availability of pass-through tax treatment for limited partnerships, regardless of size, has encouraged a significant shift in investment capital from the corporate sector to the partnership sector. It is also inconsistent with the tax law's general limitations on losses from wholly passive investments. These limitations properly extend to investments in active businesses where the number of investors involved or the legal relations between investors and the business indicate the absence of direct investor management, control, or responsibility.

A limited partnership with a large number of limited partners also presents serious audit and administrative problems for the Internal Revenue Service. An adjustment in income or loss of the partnership generates a corresponding adjustment for each of the partners. This requires a large number of returns to be held open and may necessitate multiple collection actions. Where the adjustment occurs years after the fact, transfers of partnership interests or changes in the circumstances of individual partners may have occurred so as to make collection impossible.

Proposal

A limited partnership would be treated as a corporation for tax purposes if at any time during the taxable year the partnership has more than 35 limited partners. If an S corporation were a limited partner in a partnership, each shareholder in the S corporation would be treated as a separate limited partner for purposes of the 35 limited partner rule. If a grantor trust were a limited partner, each owner of the trust would be counted as a limited partner. If a partnership were a limited partner in a second partnership, each partner in the first partnership would be treated as a limited partner in the second partnership. In addition, as under the current law S corporation rules, a husband and wife would be counted as one limited partner.

In general, the addition of the 36th limited partner to an existing limited partnership would be treated as a termination of the limited partnership and contribution of the partnership assets to a newly formed corporation.

Effective Date

In general, the proposal would be effective January 1, 1986. For limited partnerships organized before the proposal is introduced as legislation, the proposal would be effective January 1, 1990.

Analysis

The proposal would bring the treatment of corporations and limited partnerships closer to economic reality while at the same time preserving the reasonable certainty necessary for effective tax planning. The limitation proposed on the number of limited partners corresponds to the current limitation on the number of shareholders permitted in an S corporation.

Tables 1 and 2 contain estimates of the number of limited partnerships and partners that would be affected by the proposal. In 1982, approximately 15,000 limited partnerships -- less than one percent of all partnerships -- would have been taxed as corporations under the proposal. Of these limited partnerships, roughly two-thirds were engaged in two activities, oil and gas drilling and real estate, each of which has generated significant tax shelter activity. The number of partners affected would have been approximately 2.8 million. Of these, over two-thirds would have been partners with interests in oil and gas drilling and real estate.

Limited partnerships reclassified as corporations under the proposal would no longer pass through income or loss to the individual partners. In the case of a profitable limited partnership, the effects of this change on taxes paid would depend on relative corporate and personal income tax rates, the partnership's policy with regard to distribution of income, and the extent to which dividends were subject to double taxation. The Treasury Department proposals include partial relief from the double taxation of corporate earnings distributed as dividends, which could offset the effect on a profitable limited partnership of corporate classification.

In the case of an unprofitable limited partnership, corporate classification would increase tax liabilities. Partnership losses previously available to offset unrelated income of the partners would instead be deductible only against past or future income of the partnership. Under current law, losses could be carried back for three years or carried forward for 15 years against past or future partnership income.

Table 1

Number of Limited Partnerships Affected by Reclassification -- 1982 1/

Industry	Total Number of All Partnerships	Limited Partnerships With More than 35 Partners 2/
All industries	1,514,212	14,896
Agriculture	132,394	171
Mining and Drilling	55,766	3,664
Construction	64,632	13
Manufacturing	23,156	216
Finance and Insurance	155,236	3,272
Real Estate	562,575	6,257
Transportation and Communications	18,185	146
Wholesale and Retail Trade	202,531	93
Services	287,529	1,064

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

1/ Sources: Statistics of Income Bulletin (September 1984); Treasury Department estimates.

2/ Table includes all limited partnerships with more than 35 partners, regardless of whether the partnership has 35 limited partners. To the extent that some limited parnterships have more than 35 partners, but 35 or fewer limited partners, the table overstates the number of partnerships and partners that would be affected by the proposal.

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Table 2

Number of Limited Partners Affected by Reclassification -- 1982 1/

Industry	Total Number of Partners	Total Number of Partners in Limited Partnerships Partners With More than 35 Partners 2/
All industries	9,764,667	2,720,920
Agriculture	448,623	39,938
Mining and Drilling	1,574,375	995,893
Construction	149,600	1,068
Manufacturing	76,649	14,395
Finance and Insurance	2,006,381	483,932
Real Estate	3,720,805	965,611
Transportation and Communications	92,611	32,061
Wholesale and Retail Trade	485,413	4,358
Services	1,171,642	183,664

Office of the Secretary of the Treasury November 30, 1984
Office of Tax Analysis

1/ Sources: Statistics of Income Bulletin (Summer 1984); Treasury Department estimates.

2/ See note 2, Table 1.